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New Final Inversion Rules Maintain Tight Standard for Corporate Expatriations

For expatriating US companies to avoid anti-inversion rules, their foreign business activities must satisfy a tough bright-line test, consistent with controversial 2012 rules.

On June 3, 2015, the US Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) issued final regulations (the 2015 Final Regulations) under Section 7874,[1] relating to corporate inversions or expatriations. The 2015 Final Regulations largely follow temporary regulations issued on June 12, 2012 (the 2012 Temporary Regulations), which introduced a rigorous, bright-line test (discussed below) that a foreign group must satisfy in order to be treated as having "substantial business activities" in a single foreign country and thereby avoid the US anti-inversion rules. The 2015 Final Regulations will continue to make it difficult for most US-based multinational taxpayers to qualify for this exception to existing anti-inversion provisions under US tax law.

The 2015 Final Regulations' strict approach to the substantial business activities test is the latest development in the ongoing actions by policymakers within the IRS, Treasury and Congress targeting inversions and cross-border mergers. While these transactions attracted the attention of Congress more than a decade ago, resulting in the enactment of Section 7874, a more recent wave of inversions over the last several years rekindled the controversy over US companies using acquisitions by foreign corporations in order to redomicile in lower-tax jurisdictions.

Several US senators and representatives introduced legislation in 2014 to tighten existing anti-inversion rules. The proposals included reducing from 80% to 50% the amount of stock of the new combined company that must be held by former stockholders of the acquired US company in order to treat the foreign acquirer as a US corporation for US tax purposes, as well as treating the foreign acquirer as a US corporation if it had substantial business activities in the US and its "mind and management" (*i.e.*, substantially all executive officers and senior management with day-to-day decision-making responsibility) were based or primarily located in the US. As we discussed in a previous *Client Alert*, Treasury and the IRS in September 2014 issued Notice 2014-52, announcing several measures aimed at curbing inversions — and, in some respects, those measures extended beyond inversions to affect a broader range of cross-border mergers and acquisitions. Given this recent history, and the continuing intense interest in this issue in Congress, the business community and the media, the decision by Treasury and the IRS to retain the stringent bright-line substantial business activities test in the 2015 Final Regulations comes as no surprise.

The Inversion Statute

Section 7874 was enacted in 2004 under the American Jobs Creation Act to curb what Congress perceived to be a wave of corporate expatriations by major public companies. Section 7874 applies to an

acquisition of a US corporation or partnership (or substantially all of its assets) by a "surrogate foreign corporation." Unless it satisfies the substantial business activities test (the subject of the 2015 Final Regulations), a foreign corporation is treated as a surrogate foreign corporation if it meets either of the following criteria:

1. The former owners of the US corporation or partnership own 80% or more (by vote or value) of the acquiring foreign corporation by reason of their former ownership in the US corporation or partnership. In such case, the acquiring foreign corporation is treated as a US corporation for all purposes of the Code.

2. The former owners of the US corporation or partnership own at least 60% but less than 80% (by vote or value) of the acquiring foreign corporation by reason of their former ownership in the US corporation or partnership. In such case, the acquiring foreign corporation is respected as a foreign corporation, but the US corporation or partnership (and affiliates) will recognize any "inversion gain" and will be restricted in their ability to offset the gain with tax attributes such as net operating losses, credits and other income offsets. A 15% excise tax also applies to certain executive deferred compensation.

Substantial Business Activities Exception

Section 7874(a)(2)(B)(iii) provides a comprehensive exception from the treatment as a surrogate foreign corporation where the acquiring foreign corporation has, directly or through its "expanded affiliated group"[2] (EAG), substantial business activities within its jurisdiction of organization. The government's interpretation of this exception has undergone several significant revisions over the past nine years, culminating in the strict 2015 Final Regulations.

Temporary regulations issued by Treasury in 2006 provided a facts and circumstances test and a quantitative safe harbor for purposes of determining whether an EAG has substantial business activities in a particular country. The facts and circumstances test considered various factors relating to the nature and history of the EAG's business activities in the foreign country, the location of its managers and the residency of its investors. An EAG could satisfy the safe harbor, and thus be treated as satisfying the substantial business activities test, if at least 10% of its worldwide employees, assets and sales were located in the relevant foreign jurisdiction.

Subsequently, under temporary regulations issued in 2009 that superseded the 2006 regulations, Treasury retained the facts and circumstances test but withdrew the safe harbor based on a concern that it could shield transactions that are inconsistent with the purpose of Section 7874. The timing of the 2009 regulations coincided with a period of major tax reform in the United Kingdom to move toward a territorial tax system, thereby providing expatriating multinational businesses with a jurisdiction well suited to reliance on the facts and circumstances test, given the strong ties many US-based companies had developed in the UK over the years. These dynamics fed Treasury's concern over a potential wave of inversions to the UK based on the facts and circumstances test.

Then, in the 2012 Temporary Regulations, Treasury completely revoked the facts and circumstances test and replaced it with a bright-line test for whether the foreign acquiring company qualifies for the substantial business activities exception, requiring 25% of group assets, employees (by number and compensation) and sales to be in one jurisdiction. This test was heavily criticized in the business community, as it prevented virtually all companies from meeting the substantial business activities test, even if the predominant part of their business was outside the US. The 2015 Final Regulations now adopt this bright-line test with minor revisions, as discussed below.

The Group Employees, Group Assets and Group Income Tests

To qualify for the substantial business activities exception to treatment as a surrogate foreign corporation, the acquiring foreign corporation or its EAG must meet each of the following three tests:

1. The number of EAG employees based in the relevant foreign country is at least 25% of the total number of all EAG employees on the "applicable date," and the employee compensation incurred with respect to EAG employees based in the relevant foreign country is at least 25% of the total employee compensation incurred with respect to all EAG employees during the "testing period." For this purpose:

    - The "applicable date," which must be applied consistently, is either the date of the expatriation transaction or, if the taxpayer chooses, the last day of the month immediately preceding the expatriation transaction. The "testing period" is the one-year period ending on the applicable date.

    - The term "employee compensation" means all amounts incurred by the EAG that directly relate to services performed by EAG employees, including, for example: wages, salaries, deferred compensation, employee benefits and employer payroll taxes. The 2015 Final Regulations clarify that the amount and timing of employee compensation is based on when it would be deductible by the employer as compensation. The timing and the amount of the deduction must be determined for all EAG employees either under US federal income tax principles or based on the relevant tax laws (meaning, generally, under the tax law to which the relevant EAG member is subject). For example, if an EAG's two members are a US entity (USP) and the foreign acquiring entity subject to the tax law of Country X (FA), the EAG may determine the timing and the amount of the compensation deduction either (i) under US federal income tax principles, or (ii) based on Country X's tax law for the individuals who perform services for FA and based on US federal income tax principles for the individuals who perform services for USP.

    - The 2015 Final Regulations also clarify that whether individuals are considered "employees" for purposes of this test must be determined for all EAG employees under US federal income tax principles or for all EAG employees based on the relevant tax laws.

2. The value of EAG assets located in the relevant foreign country is at least 25% of the total value of all EAG assets on the applicable date. For this purpose:

    - Assets include tangible personal property or real property used or held for use in the active conduct of a trade or business by the EAG. Intangible assets are not included in this determination.

    - An asset is considered to be located in the relevant foreign country only if the asset was physically present in such country as of the date of the expatriation transaction and for more time than in any other country during the testing period. The 2015 Final Regulations modify this rule to account for assets that are mobile in nature and are used in transportation activities, such as vessels, aircraft and motor vehicles. Such assets need not be physically present in the relevant foreign country as of the date of the expatriation transaction, as long as they were physically present in that country for more time than in any other country during the testing period.

    - Assets are valued on a gross basis, and any rented property is valued at eight times the annual rent.

3. The EAG's income derived in the relevant foreign country is at least 25% of the total EAG income during the testing period. For this purpose:

    - Income means gross income from transactions occurring in the ordinary course of business with customers that are not related persons.

    - Income is considered derived in the relevant foreign country only if it is derived from a transaction with a customer located in such country.

    - The 2015 Final Regulations clarify that group income must be determined consistently for all EAG members either under US federal income tax principles or as reflected in the relevant financial statements, meaning, generally, financial statements prepared in accordance with US Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

The 2015 Final Regulations retain a number of anti-abuse provisions from the 2012 Temporary Regulations, designed to ignore assets, employees or income that are transferred to the relevant foreign country as part of a plan with "a principal purpose" of avoiding the purposes of Section 7874, or for which there is a plan to transfer group assets or group employees out of the relevant foreign country.

In addition, the 2015 Final Regulations provide that status as an EAG member takes into account all transactions related to the expatriation transaction — and the preamble to the 2015 Final Regulations clarifies that such related transactions may occur after the date of the expatriation transaction, citing to principles of Section 7874(a)(2)(B) and Notice 2014-52.

Conclusion: The Anti-Inversion Drumbeat Continues

Over the past nine years of interpretive guidance on the substantial business activities exception to the anti-inversion rules, Treasury and the IRS have charted a path from a facts and circumstances test with a 10% safe harbor, to withdrawing the safe harbor, to implementing a stringent bright-line rule. Given the nature of global business, even companies that have a relatively large "footprint" outside of the US would typically find it difficult to meet a threshold of 25% of employees (by number and compensation), assets and income from transactions with customers in the relevant foreign country. In the preamble to the 2015 Final Regulations, Treasury and the IRS rejected comments that the 25% threshold was too high in general, as well as a proposal to require an EAG to satisfy the 25% threshold with respect to two of the three factors as long as the EAG averaged 25% on all three tests. By finalizing the 25% bright-line test applicable to employees, assets and income, Treasury and the IRS are, not surprisingly, holding firm on policies designed to discourage US companies from considering expatriation transactions.

Other recent developments point in the same direction. For example, on May 20, 2015, Treasury released proposed changes to the 2006 US model income tax treaty that would deny treaty benefits and thereby impose full withholding tax on dividends, interest, royalties and other income payments made by a US company that expatriates under Section 7874 (along with all US affiliates), for 10 years following the expatriation transaction. In addition, Notice 2014-52 stated future guidance may address "earnings stripping" practices such as the excessive use of related-party debt, which, according to Treasury, US corporations have used to reduce US-source earnings. Even though such future guidance will apply prospectively, Treasury and the IRS said they expect that, to the extent any tax avoidance guidance applies only to inverted groups, the guidance would apply to groups that inverted on or after September 22, 2014, the date Notice 2014-52 was issued. This shifting landscape merits close watch by the business and adviser communities.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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Endnotes

1 All section references in this *Client Alert* are to the Internal Revenue Code of 1986, as amended (the Code).

2 Generally, the members of the entity's expanded affiliated group are its more-than-50-percent affiliates.